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No. 06-172

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SUPREME COURT, U.S.

In The

Supreme Court of the United States

RONALD J. SOMMERS, TRUSTEE,

Petitioner,

v.

WELLS FARGO BANK OF TEXAS, N.A.,

Respondent.

On Petition For A Writ Of Certiorari To The United States Court Of Appeals For The Fifth Circuit

BRIEF IN OPPOSITION

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QUESTIONS PRESENTED

1. Whether Petitioner has presented a compelling reason to grant the Petition, where the Fifth Circuit correctly applied well-established principles governing the use of *nunc pro tunc* orders?

2. Whether Petitioner has presented a compelling reason to grant the Petition, where the Fifth Circuit, contrary to Petitioner's assertion, did not reach the question of whether a "lift-stay" order issued by a bankruptcy judge constitutes a form of issue preclusion?

3. Whether Petitioner has presented a compelling reason to grant the Petition, when the underlying "bankruptcy law remedy" that he sought, namely substantive consolidation, is itself an invalid remedy?

CORPORATE DISCLOSURE STATEMENT PURSUANT TO SUPREME COURT RULE 29.6

Respondent Wells Fargo Bank, N.A. has the following parent company: Wells Fargo & Company (NYSE:**WFC**)

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STATEMENT

Respondent generally adopts as its statement the court of appeals' recitation of the background facts. *See* Petitioner's Appendix ("App.") at 2-7. Pursuant to the obligations imposed by Supreme Court Rule 15(2), Respondent perceives several material misstatements of law and fact in the Petition for a Writ of Certiorari (the "Petition").

First, the Petition asserts that the court of appeals established a rule that an order lifting the stay has an "estoppel" or "issue preclusive" effect. As will be argued herein, the court of appeals actually held that *nunc pro tunc* "substantive consolidation"[1] relief was unavailable under the facts presented.

Second, with respect to factual matters, the Respondent denies that it has "gamed the system." No lower court made such a finding. Respondent denies the Petitioner's suggestion that Respondent engaged in misconduct in collecting the debts owed in these bankruptcy cases. The bankruptcy judge made no fact finding that Respondent misled the Petitioner or any creditor. To be sure, the bankruptcy judge made a vague reference to Respondent's supposed "knowledge" as a basis to hold that the Respondent was not "unfairly harmed" by substantive consolidation. App. at 59. However, the bankruptcy judge never made a finding of what exactly the Respondent knew, and why such knowledge justified the bankruptcy court's stripping the Respondent of its liens.

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[1] The term "substantive consolidation" will be defined in argument 3 herein.

SUMMARY OF ARGUMENT

Petitioner has presented no "compelling reasons" for his Petition to be granted. *See* Sup. Ct. R. 10. Petitioner has failed to demonstrate that the Fifth Circuit's March 31, 2006 Opinion ("Opinion") is in conflict with a decision of this Court or another court of appeals.

Petitioner contends that the courts of appeals are split on whether an order modifying the automatic stay serves to preclude remedies under bankruptcy law. Petition at 11. More directly, Petitioner contends that the Fifth Circuit's Opinion exemplifies a holding on issue preclusion. This argument is belied by the text of the Fifth Circuit's Opinion. Notably the Opinion makes no reference to collateral estoppel, res judicata or issue preclusion.

Instead the Fifth Circuit's Opinion exemplifies a correct application of *nunc pro tunc* principles in bankruptcy cases. In its application of these equitable, factually driven principles, the Fifth Circuit weighed the actions taken by Respondent in reliance upon a lift-stay order. Based upon Respondent's reliance the court of appeals concluded that *nunc pro tunc* relief was unavailable to undo the actions taken by Respondent.

Petitioner further argues that the Fifth Circuit has made an erroneous application of issue preclusion principles that bars "bankruptcy law remedies" generally. However the remedy sought by Petitioner below, namely "substantive consolidation," is not a valid bankruptcy law remedy. In weighing whether to grant certiorari, the Court should consider whether Petitioner's underlying assumption as to the validity of substantive consolidation is correct.

ARGUMENT

1. The Opinion below correctly applies *nunc pro tunc* principles.

There is no conflict among the circuits on the issue actually decided below. The issue decided was whether "the bankruptcy court erred in issuing the order to consolidate *nunc pro tunc*." App. at 7.

The court of appeals' stated rationale for reversal falls squarely within well established principles governing *nunc pro tunc* orders. Black's Law Dictionary defines *nunc pro tunc* as relief that has a retroactive legal effect. Black's Law Dictionary (7th ed. 1999). In *Mitchell v. Overman*, 103 U.S. 62 (1880), the Court concluded that *nunc pro tunc* orders are allowed in limited circumstances, such as where the delay in entry of an order was caused by the court's convenience or some cause not attributable to the laches of the parties. In that regard the Court held that lower courts should look at the particular circumstances of the case and weigh the equities of the relief.

Nunc pro tunc relief in bankruptcy cases is a separate and distinct principle from issue preclusion. For example, in *In re Triangle Chemicals, Inc.*, 697 F.2d 1280, 1288-89 (5th Cir. 1983), the court of appeals held that the bankruptcy court had discretion to appoint an attorney to serve as counsel on a *nunc pro tunc* basis. However, the court of appeals also observed that it allows *nunc pro tunc* orders only in "rare or exceptional circumstances." *Id.* 1289. Because counsel had "performed valuable services for the debtor's estate that have increased the common funds available for distribution to the creditors" the court of appeals recognized a limited discretion should be available

for *nunc pro tunc* relief as necessary to avoid a windfall for creditors.

In the case at hand, the narrow issue decided by the court of appeals is whether a bankruptcy court may issue a substantive consolidation order, on a *nunc pro tunc* basis, when the effect of granting retroactive relief is to nullify actions taken by a creditor in reliance on a prior lift-stay order. Respondent relied upon the lift-stay order in prosecuting a collection action against the debtor's stockholder. The court of appeals correctly applied *nunc pro tunc* principles in concluding that the lower court erred in granting relief. In substance the court of appeals has held that a bankruptcy trustee in the bankruptcy case of a later-in-time filed debtor may not obtain *nunc pro tunc* equitable relief that back-dates the later-filed debtor's bankruptcy petition date, if (i) a creditor of the later-filed debtor has acted in reliance upon an order of the bankruptcy court issued in a case concerning an affiliate of such later-filed debtor, and (ii) *nunc pro tunc* relief in the later-filed debtor's case would prejudice such creditor.

In addition to correctly applying general *nunc pro tunc* principles, the Fifth Circuit's holding is faithful to the text of the Bankruptcy Code. This is shown by reference to four key dates:

February 4, 2002	A Texas corporation files for bankruptcy. App. at 3.
April 10, 2002	Such corporation's stockholder (a natural person) and Respondent enter into a forbearance agreement, under which certain of the stockholder's assets are pledged to Respondent. App. at 3.

July 11, 2002	The Petitioner as trustee for the corporation files an application to substantively consolidate the stockholder with the corporation. App. at 3.
December 11, 2002	The stockholder files for bankruptcy. App. at 4.

By granting a *nunc pro tunc* consolidation order, the bankruptcy judge effectively back-dated the December 11 filed case to a February 4 dated case. This prejudiced the Respondent because Section 549(a) of the Bankruptcy Code[2] permits the bankruptcy trustee to avoid all transfers made after the "commencement of the case." Normally this bright-line rule makes sense. Anyone dealing with assets of a person in bankruptcy is placed on notice that bankruptcy court approval is required before the transaction is binding. But if a bankruptcy judge has power to consolidate a debtor and non-debtor affiliate (who later files a separate bankruptcy petition) on a *nunc pro tunc* basis, third parties will be reluctant to enter into transactions with the non-bankrupt affiliates, as these transactions become subject to Section 549 avoidance. That is what happened below. The Respondent reached an agreement with a natural person eight months before he filed for bankruptcy. Liens granted by this person prior to the "commencement of [his] case" are not avoidable under the plain meaning of Section 549 of the Bankruptcy Code.

The bankruptcy judge's order which "back-dated" the "commencement of the case" under a *nunc pro tunc* rule, blurs the bright-line rule codified in Section 549(a), creating

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[2] 11 U.S.C. § 101 et seq.

a result that is at odds with the Bankruptcy Code. This result cannot be justified using general equity powers. As this Court explained in *Norwest Bank Worthington v. Ahlers*, 485 U.S. 197, 206 (1988), whatever equitable powers remain in bankruptcy courts must and can only be exercised within the confines of the Bankruptcy Code.

The Fifth Circuit's limitation on *nunc pro tunc* substantive consolidation relief in this case promotes out-of-court settlements between creditors and borrowers who happen to be affiliated with an entity in bankruptcy. The District of Columbia Circuit recognized this important policy consideration when it imposed similar restrictions on the use of *nunc pro tunc* substantive consolidation relief in *Drabkin v. Midland-Ross Co.* (*In re Auto-Train Corp.*) 810 F.2d 270, 276 (D.C. Cir. 1987):

> Were bankruptcy courts permitted to consolidate entities *nunc pro tunc* without regard to transferees' reliance on an entity's apparent separateness, a sign of weakness in any member of a family of corporations would lead creditors to descend on each member, strong or weak, to claim their pound of flesh. Such a rule would also sharpen people's natural reluctance to extend credit to any affiliate of a financially troubled corporation. This in turn would imperil the ability of financially sound affiliates to continue operations and help the more troubled ones out of their predicament.

In sum, the court of appeals' disposition of the appeal below is based solely upon *nunc pro tunc* principles. The Fifth Circuit's Opinion is not in conflict with any precedent of this Court, nor the holdings of other circuits.

2. The "issue preclusion" conflict is illusory.

Petitioner's contention, that the Fifth Circuit's Opinion conflicts with other circuits by holding that lift-stay orders have a preclusive effect, is belied by inspection of the text of the Opinion, which does not contain any of the following terms of art: (i) *res judicata*, (ii) collateral estoppel, (iii) claim preclusion, or (iv) issue preclusion. Yet Petitioner argues that the Fifth Circuit is in conflict with the First, Seventh, Ninth and Eleventh Circuits with respect to principles of issue preclusion in bankruptcy.[3]

In truth the Fifth Circuit is in agreement with the First, Seventh, Ninth and Eleventh Circuits, having held in other cases that lift-stay orders are summary proceedings with little preclusive effect. For example, in *In re Little Creek Dev. Co.*, 779 F.2d 1068, 1074 (5th Cir. 1986), the Fifth Circuit observed that counterclaims may not be asserted in automatic stay litigation because of the expedited treatment required of stay motions. Furthermore, in *D-1 Enters., Inc. v. Commercial State Bank*, 864 F.2d 36, 40 (5th Cir. 1989), the Fifth Circuit held that orders issued in "contested matters" (including lift-stay orders) do not bar other claims under the *res judicata* doctrine.

In sum, Petitioner requests this Court to review an issue that was not decided below. But even if this issue had been reached, there is no material conflict among the circuits on this issue. Accordingly, the Petition does not meet this Court's criteria for certiorari review.

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[3] None of the cases cited by Petitioner concern *nunc pro tunc* orders, the issue actually decided below.

3. The real problem illustrated by the litigation below is the unprincipled (and invalid) remedy of substantive consolidation.

The "Questions Presented" found on page (i) of the Petition make clever use of the phrase "bankruptcy law remedies." This is because the "bankruptcy law remedy" at issue here, namely substantive consolidation, will be shown to be invalid upon application of this Court's jurisprudence. Respondent will show that assuming *arguendo* the court of appeals erred in an application of issue preclusion principles, such error is harmless because the underlying remedy of substantive consolidation is itself invalid.

This litigation arose out of Petitioner's selection of a uncharted "nuclear weapon" called substantive consolidation. Substantive consolidation is a federal judge made remedy that results in a merger of separate entities so that their assets and liabilities may be aggregated. The federal courts that have authorized this relief explain that the nature and effect of substantive consolidation closely resembles a statutory corporate merger, except that the rights of creditors (instead of stockholders) are affected. Substantive consolidation usually results in the pooling the assets of, and claims against, the two entities; satisfying liabilities from the resulting common fund; eliminating inter-company claims; and combining the creditors of the two companies. *See Union Savings Bank v. Augie/Restivo Baking Co., Ltd.* (*In re Augie/Restivo Baking Co.*), 860 F.2d 515, 518 (2nd Cir. 1988)

The substantive consolidation remedy is "uncharted" in the sense that Congress has not provided statutory authority for the remedy. This Court has never adopted the doctrine in a *stare decisis* sense, nor has it provided

standards for its usage. Indeed this Court has repeatedly held it is the province of Congress to provide a federal law remedy to enforce a substantive right in federal court. *See, e.g., Touche Ross & Co. v. Redington*, 442 U.S. 560, 578 (1979). Substantive consolidation is "nuclear" in the sense that contrary to bedrock corporate law principles, it results in a corporate shareholder's assets becoming available to the corporation's creditors.[4]

Corporate law (including corporate mergers) is based for the most part on statutes enacted by state legislators. How then have many of our federal courts authorized the remedy of substantive consolidation of corporations without statutory authority? As shown below, by "federal-izing" state alter-ego law.

A. *Its short history*. Substantive consolidation emerged as a federal law concept in the 1960's and 70's in a series of holdings issued by the Second Circuit. Starting with *Soviero v. Franklin Nat'l Bank of Long Island*, 328 F.2d 446, 448 (2nd Cir. 1964), the Second Circuit rejected a creditor's contention that corporate veils can be pierced only in cases of fraud (as required by state law). Then in *Chemical Bank v. Kheel*, 369 F.2d 845, 847 (2nd Cir. 1966) the Second Circuit relied not solely on state law alter-ego factors, but also on the sheer cost of sorting out the various rights and obligations. The contours of this new federal judge-made law of consolidation was further developed by the Second Circuit in *Flora Mir Candy Corp.*

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[4] *United States v. Bestfoods*, 524 U.S. 51 (1998) "It is a general principle of corporate law deeply 'ingrained in our economic and legal systems' that a parent corporation (so-called because of control through ownership of another corporation's stock) is not liable for the acts of its subsidiaries."

v. R. S. Dickson & Co. (*In re Flora Mir Candy Corp.*), 432 F.2d 1060, 1062-63 (2nd Cir. 1970). Here a "creditor reliance" inquiry (again, having no basis in state alter ego law) became determinative. Finally, in *James Talcott, Inc. v. Wharton* (*In re Continental Vending Mach. Corp.*), 517 F.2d 997, 1000-02 (2nd Cir. 1975), *cert. denied*, 424 U.S. 913 (1976) the Second Circuit concluded its development of consolidation principles under the former Bankruptcy Act, allowing a hybrid form of consolidation. The modern term "substantive consolidation" appears in a reported decision for the first time in 1977. In *In re Commercial Envelope Manufacturing Co.*, a bankruptcy court observes: "[s]ubstantive consolidation, as will be seen, is now part of the warp and woof of the fabric of the bankruptcy process involving related debtors, though to be used sparingly."[5]

In the 1980's, the Second Circuit collapsed its prior holdings into a two-pronged balancing test. Specifically in *In re Augie/Restivo Baking Co., Ltd.*, 860 F.2d 515, 518-19 (2nd Cir. 1988), the court of appeals held that a bankruptcy court may grant substantive consolidation upon answering either of the following questions in the affirmative: (i) whether creditors dealt with the entities as a single economic unit and "did not rely on their separate identity in extending credit,". . . .; or (ii) whether the affairs of the debtors are so entangled that consolidation will benefit all creditors."

Other circuits followed suit announcing their own standards, such as the balancing test for substantive

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[5] 3 Bankr. Ct. Dec. (CRR) 647, 648, 14 Collier Bankr. Cas. (MB) 191, 192 (S.D.N.Y. 1977).

consolidation found in *Eastgroup Properties v. Southern Motel Ass'n, Ltd.*, 935 F.2d 245, 249 (11th Cir. 1991):

> The proponent of substantive consolidation must show that (1) there is substantial identity between the entities to be consolidated; and (2) consolidation is necessary to avoid some harm or to realize some benefit. When this showing is made, a presumption arises that creditors have not relied solely on the credit of one of the entities involved. Once the proponent has made this prima facie case for consolidation, the burden shifts to an objecting creditor to show that (a) it has relied on the separate credit of one of the entities to be consolidated; and (b) it will be prejudiced by substantive consolidation.

Those courts adopting substantive consolidation have acknowledged that the doctrine lacks a statutory foundation, and further that it represents a significant departure from state law. *See FDIC v. Colonial Realty Co.*, 966 F.2d 57, 59-61 (2nd Cir. 1992), in which the Second Circuit summarized the difference between state "alter ego" law and federal "substantive consolidation" principles as follows: "[t]he focus of piercing the corporate veil is the limited liability afforded to a corporation;" whereas, the focus of substantive consolidation is "the equitable treatment of all creditors." However use of this federal common law methodology aimed at achieving "equitable treatment" for all creditors has created difficult interpretive problems for parties and courts.

B. *Interpretive Problems.* In practice the federal judge-made "balancing tests" have not provided much predictability. While these balancing tests give lip service to the proposition that the consolidation remedy is unavailable if a creditor demonstrates prejudice, the case at

hand demonstrates how illusory this creditor protection is in practice. The bankruptcy court below ignored the Respondent's "lien-striping" prejudice, concluding instead that substantive consolidation is permitted so long as the objecting creditor is "not unfairly harmed." App. at 59. However, reliance upon a bankruptcy judge's individualized notion of "fairness" is anathema to the rule of law. Substantive consolidation, lacking any real limitations on its applicability, lends itself to such judicial mischief.

Under the current standards in vogue among the circuits, one cannot answer, with any certainty, basic questions such as: (i) whether a bankruptcy court may substantively consolidate a non-debtor entity with a debtor in bankruptcy, (ii) whether the entities to be consolidated must have a 100% direct ownership affiliation (i.e. no minority shareholders), and (iii) whether retroactive (*nunc pro tunc*) consolidation is permitted?

Not surprisingly the courts that have adopted substantive consolidation disagree on such issues, as well as the frequency with which consolidation should be used.[6] Some courts of appeals make reference to a "liberal trend" favoring increased use of substantive consolidation, while others disavow such trend and instead have announced standards which severely restrict the use of consolidation. Compare the Eleventh Circuit's *Eastgroup Property* opinion, 935 F.2d at 248-49, with the Third Circuit's opinion in *Credit Suisse First Boston v. Owens Corning*

[6] While a full discussion of the many varieties of substantive consolidation is unnecessary for the purpose of this Brief, Respondent notes that three of our courts of appeals (the Fifth, Sixth and Seventh Circuits) have not yet adopted any form of the doctrine in a *stare decisis* sense.

("*Owens Corning*"), 419 F.3d 195, 209, footnote 15 (3rd Cir. 2005), *cert. denied*, 126 S.Ct. 1910 (May 1, 2006). All of these conflicting observations leave parties and lower courts guessing what standard for consolidation will apply to a given set of facts.

Substantive consolidation will always harm certain creditor groups as priorities among creditors of separate entities are altered. "Because the entities sought to be consolidated frequently will have different debt-to-asset ratios, substantive consolidation invariably redistributes wealth among the entities' creditors." *E.g.*, *Eastgroup Properties v. Southern Motel Ass'n, Ltd.*, 935 F.2d 245 (11th Cir. 1991) (quoting *Drabkin v. Midland-Ross Co.* (*In re Auto-Train Corp.*), 810 F.2d 270, 276 (D.C. Cir. 1987)). While some courts cite "efficiency" as the bankruptcy policy objective achieved by the doctrine, other voices question whether the supposed efficiency outweighs the costs of this rule. *See*, *e.g.*, Richard A. Posner, *The Rights of Creditors of Affiliated Corporations*, 43 U. CHI. L. REV. 499, 518 (1976) Posner argues that "[t]o the extent that one of the bankrupts has greater assets relative to the claims of its own creditors than the other has, consolidation harms those creditors and helps the affiliate's creditors. The prospect of consolidation means that a creditor can make a total evaluation of the risks that he faces only by considering the risk of insolvency of the borrower's affiliates as well as the risk of insolvency of the borrower itself." With the passage of time, Posner's prediction that substantive consolidation would increase the cost of credit has become manifest. For example in the current marketplace for loans, borrowers frequently encounter the significant expense of law firm legal opinions designed to reduce the risk of consolidation, and which by "custom and

practice this type of counsel opinion is requested and given for newly formed entities whose 'special purpose' is to obtain structured financing (i.e., where 'a defined group of assets . . . [are] structurally isolated, and thus serve as the basis of financing." Committee on Bankruptcy and Corporate Reorganization of The Association of the Bar of the City of New York, *Structured Financing Techniques*, 50 Bus. Law 527, 529 (1995).

C. *The Constitutional Problem.* While parties and courts have spent countless hours fussing over the rules of decision, surprisingly little attention has been given to whether there is a judicial power to grant substantive consolidation relief. The authority for federal judge-made substantive law is problematic. Based upon separation of power concerns, this Court has held that federal courts lack authority to promulgate generalized standards which have the effect of adjusting priorities in bankruptcy cases. *See U.S. v. Noland*, 517 U.S. 535 (1996), and *U.S. v. Reorganized CF&I Fabricators of Utah, Inc.*, 518 U.S. 213 (1996). Yet the federal judge made doctrine of substantive consolidation, by merging assets and liabilities of a parent and subsidiary, modifies the state-law based priority that creditors of the subsidiary normally have to the assets of the subsidiary. In *Noland* and *CF&I Fabricators*, this Court explained that promulgation of generalized rules which categorically modify priorities in bankruptcy is a legislative function, not a judicial function. Under this reasoning, even though legislatures have not established standards for substantive consolidation, the courts are not by implication authorized to perform a legislative function such as announcing general standards for substantive consolidation.

Consistent with such separation of powers concerns, this Court has directed the federal courts to look to state law for the sources of substantive law, absent a federal statute authorizing the relief requested. *See Erie R.R. Co. v. Tompkins*, 304 U.S. 64 (1938). Eventually this principle was applied in the bankruptcy context as well. *See Butner v. United States*, 440 U.S. 48, 55 (1979) (property interests are created and defined by state law, unless some federal statute or federal interest requires a different result). *See also Raleigh v. Illinois Department of Revenue*, 530 U.S. 15 (2000) (holding that the validity of a claim in bankruptcy is generally a function of underlying state law).

State law does not recognize "substantive consolidation" *per se*. Nevertheless, the perception persists that federal courts have the power to both grant and promulgate standards for substantive consolidation using federal common law and equity principles. Just last year the Third Circuit introduced its discussion of substantive consolidation as follows: "[s]ubstantive consolidation, a construct of federal common law, emanates from equity." *Owens Corning*, 419 F.3d at 205. Such courts have misrelied upon equity, federal common law, and this Court's precedents.

(i) *Misreliance upon equity.* Reliance upon federal equitable principles as authority for substantive consolidation is unwarranted under this Court's decisions. In 1999 the Court explicitly restricted the use of federal equity powers to those equitable remedies that existed in the English Court of Chancery in 1789. *See Grupo Mexicano de Desarrollo, S.A. v. Alliance Bank Fund, Inc.*, 527 U.S. 308 (1999) (reversing pre-judgment injunctive relief as unavailable in 1789). *See also Great West Life and Annuity Ins. Co. v. Knudson*, 534 U.S. 204 (2002) (holding this 1789

equity cutoff principle applies to a request for equitable relief under ERISA, which arguably like the Bankruptcy Code is a "comprehensive and reticulated statute"). *See also Norfolk Shipbuilding & Drydock Corp. v. Garris, Administratrix*, 532 U.S. 811, 820 (2001), in which the Court observes with respect to its prior holding in *Grupo Mexicano* that the "equitable lawmaking power of bankruptcy courts [is] limited by statute."

The remedy of substantive consolidation did not exist in the English Court of Chancery in 1789, and does not exist in England today. Contemporary English lawyers have observed that English courts have not followed the lead of the American courts in developing a substantive consolidation doctrine. *See* Simon Bowmer, *To Pierce or Not to Pierce the Corporate Veil: Why Substantive Consolidation is Not an Issue under English Law*; 15 Journal of International Banking Law 193 (Issue 8, August, 2000).

Application of the *Grupo Mexicano* principle to bankruptcy courts, being units of the federal district courts, eliminates substantive consolidation as a viable federal judge made equitable remedy. The court of appeals below seemed to recognize this probable outcome. The Fifth Circuit's Opinion makes passing reference to *Grupo Mexicano*, but the court of appeals decided to defer ruling on the issue until another day choosing instead to make a narrower *nunc pro tunc* holding. App. at pages 6, 7 and 13.

Respondent is duty-bound to disclose that several courts have concluded that the *Grupo Mexicano* decision has had no impact on substantive consolidation, including

the Third Circuit[7] in *Owens Corning*, 419 F.3d at 206, *In Re American Homepatient, Inc.*, 298 B.R. 152 (Bankr. M.D. Tenn., 2003), and *In re Stone & Webster, Inc.* 286 B.R. 532 (Bankr. D. Del. 2002). These courts rely upon this Court's decision in *Sampsell v. Imperial Paper & Color Corp.*, 313 U.S. 215 (1941) ("*Sampsell*") as *stare decisis* authority for substantive consolidation. But did this Court really invent substantive consolidation back in 1941?

(ii) *Misreliance upon Sampsell.* Careful reading of *Sampsell* reveals that instead of authorizing substantive consolidation, the Court only ruled on whether the court of appeals had correctly granted a priority claim in bankruptcy. A similar bankruptcy priority dispute was decided by the Court last term in *Howard Delivery Service, Inc. v. Zurich American Insurance Co.*, 547 U.S. ___, 126 S.Ct. 2105 (2006). In *Howard Delivery* this Court cites *Sampsell* for the proposition that "[t]he theme of the Bankruptcy Act is 'equality of distribution', . . . and if one claimant is to be preferred over others, the purpose should be clear from the statute." 126 S.Ct. at 2116.

In *Sampsell* a bankruptcy trustee had asserted that an individual debtor's transfer of his property to an affiliate corporation was not in good faith, and was made for the purpose of placing it beyond the reach of the individual's creditors. Based upon these facts, the bankruptcy referee granted an order directing the affiliate to show cause why its assets should not be marshaled for the

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[7] Remarkably, the Third Circuit concludes this Court approved substantive consolidation six decades ago. Then the Third Circuit qualifies its assertion stating this Court approved it "at least indirectly and perhaps inadvertently." *See Owens Corning*, 419 F.3d at 206. This is hardly a ringing endorsement.

benefit of the creditors of the individual. After a hearing, the bankruptcy referee granted the trustee relief against the affiliate corporation, and the trustee took possession of its assets.

In a subsequent "claim objection" type proceeding in the individual debtor's case, a creditor of the corporation, who was not a party to the earlier proceeding, filed a claim asserting priority to the corporate assets. The Court noted that the initial bankruptcy court order had not adjudicated the priority of creditors of the corporation vis-a-vis the creditors of the debtor stockholder. While normally creditors of the corporation would be entitled to satisfy their claims out of corporate assets prior to any participation by the creditors of the individual stockholder, here the corporate creditor was found to have had knowledge regarding the fraudulent transfer of assets from the stockholder to the corporation. Furthermore, the corporate creditor was neither a "lien creditor nor an innocent grantee for value." *Id.* at 220. Concluding that the bankruptcy referee had subject matter jurisdiction to direct the turnover of the affiliate's assets, the Court held that the creditor could not collaterally attack the prior order and held that the corporate creditor should have no priority claim under the facts presented.

Clearly the Court in *Sampsell* did not reach the issue of whether an order of "substantive consolidation" (as that term is now used) between a debtor and an affiliate was a proper exercise of judicial power. Rather *Sampsell's* holding exemplifies an application of the well-established prohibition against "collateral attack" of judgments. Generally, the policy against collateral attack precludes a subsequent challenge to an otherwise final order so long as the court that issued the order had subject matter

jurisdiction to issue that general kind of order, and regardless of whether the specific relief granted was correct from a substantive point of view. *Sampsell* was decided under the former Bankruptcy Act of 1898, when the summary/plenary jurisdiction dichotomy resulted in uncertainty as to a bankruptcy referee's subject matter jurisdiction. *Sampsell's* true holding is that in the context of an individual and his family owned corporation, such corporate entity could not insist on a plenary suit. *Id.* at 218. Because this Court concluded the bankruptcy referee had subject matter jurisdiction, the referee's prior order directing the corporation to turnover assets could not be collaterally attacked by the corporate creditor.[8]

How is it that several lower courts have misinterpreted *Sampsell* as this Court's *stare decisis* endorsement of substantive consolidation? The Court recently signaled the probable cause of the confusion. Justice Ginsburg, writing on behalf of the Court in *Arbaugh v. Y&H Corp. d/b/a The Moonlight Café,* 546 U.S. ___, 126 S.Ct. 1235 (2006), noted that: "[j]urisdiction, this Court has observed, is a word of many, too many, meanings. This Court, no less

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[8] Subsequent to the publication last year of the *Owen's Corning* opinion, several commentators have published articles openly skeptical of the Third Circuit's conclusion that *Sampsell* is *stare decisis* on the issue of the power of the bankruptcy court to consolidation. Professor Douglas G. Baird of the University of Chicago Law School writes that "the U.S. Supreme Court has never formally embraced the concept" and that while Justice Douglas came "closest to doing so" in the *Sampsell* case, *Sampsell* merely involved a recovery of assets that had been fraudulently conveyed. *See* Douglas G. Baird, *Substantive Consolidation Today*, Vol. XLVII Boston College Law Review 1, 15 (December 2005). Further arguments regarding the limited holding of the *Sampsell* case are found in Sabin Willett, *The Doctrine of Robin Hood, A Note on "Substantive Consolidation,"* 4 DePaul Business & Commercial Law Journal 87 (Fall 2005).

than other courts, has sometimes been profligate in its use of the term," and that with respect to "the subject-matter jurisdiction/ingredient-of-claim-for-relief dichotomy, this Court and others have been less than meticulous." (internal quotation marks omitted). 126 S.Ct. at 1242. So while *Sampsell* concerned subject matter jurisdiction – whether the bankruptcy referee had summary jurisdiction over a corporation owned by the bankrupt's family – Respondent suggests that *Sampsell's* use of the word "jurisdiction" has led some lower courts erroneously to conclude that *Sampsell* created a new federal cause of action now known as substantive consolidation.

(iii) *Misreliance upon federal common law.* Finally the Third Circuit cites "federal common law" as yet another basis for federal courts to invent substantive consolidation. *Owens Corning* at 205. However our circuits are in conflict over the notion of a federal common law of bankruptcy. In *Walker v. Cadle Co.*, 51 F.3d 562, 567 (5th Cir. 1995), the Fifth Circuit declined to invent a federal common law right of contribution among parties which violated the automatic stay in bankruptcy cases, reasoning that "bankruptcy is not an area where the courts have wide discretion to fashion new causes of action." In accord *see In re Consolidated Freightways Corp.*, 443 F.3d 1160 (9th Cir. 2006).

With respect to the availability of federal common law, this Court in *United States v. Kimbell Foods, Inc.*, 440 U.S. 715, 728 (1979) established a durable test requiring the federal courts to evaluate (1) whether a uniform national rule is required to effectuate the federal program's purpose; (2) whether application of a state law rule would conflict with a policy underlying the federal program; and (3) whether application of a uniform federal rule would

upset existing relationships predicated on state law. Following *Kimbell*, the Court repeatedly has eschewed reliance upon federal common law principles where doing so would upset state corporate law principles. *See, e.g., United States v. Bestfoods*, 524 U.S. 51, 63 (1998) (the Court declines to displace state corporation law using a federal common law of alter ego to fashion a CERCLA remedy against a parent company); *O'Melveny & Meyers v. FDIC*, 512 U.S. 79 (1994) (the Court unanimously rejects a federal common law scheme that displaced traditional matters of state concern, such as corporate governance and whether the knowledge of corporate directors may be imputed to the corporation); and *Atherton v. FDIC*, 519 U.S. 213 (1997) (the Court again held that absent a significant conflict between some federal policy or interest and state law, courts must refrain from fashioning rules of federal common law). Furthermore, this Court has already signaled that generally a federal common law of bankruptcy should not provide the rules of decision in bankruptcy disputes. *See Butner v. United States*, 440 U.S. 48 (1979).

At present state law governs corporate mergers, alter ego, property ownership, and creditor's rights. A federal common law rule of substantive consolidation would displace state law based rights and expectations on such issues. Federal common law should only supplant state law when there is a need for a uniform rule to protect an interest under some federal program or statute. None is evident here.[9]

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[9] The Petitioner argued below that substantive consolidation is authorized by Section 105(a) of the Bankruptcy Code which states, in pertinent part: "the court may issue any order, process, or judgment

(Continued on following page)

The point of this argument is that the Court should not assume that substantive consolidation actually constitutes a valid "bankruptcy law remedy" as implicated by Petitioner's Questions Presented. To be sure, the Petitioner does not present the substantive consolidation issue directly for review, focusing instead on an illusory circuit conflict premised upon lift-stay orders. However, an alternative ground for denial of the Petition is that it is premised upon the incorrect notion that substantive consolidation is a valid "bankruptcy law remedy." Thus even if the court of appeals had erred with respect to issue preclusion, the error is harmless.

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that is necessary or appropriate to carry out the provisions" of the Code. 11 U.S.C. § 105(a). However, the problem with this argument is that there is no "provision" of the Code to be carried out by substantive consolidation in the Chapter 7 bankruptcy cases below. As explained by the Second Circuit in *In re Dairy Mart Convenience Stores, Inc.*, 351 F.3d 86, 92 (2nd Cir. 2003), "the equitable power conferred on the bankruptcy court by section 105(a) is the power to exercise equity in carrying out the *provisions* of the Bankruptcy Code, rather than to further the purposes of the Code generally, or otherwise to do the right thing. This language suggests that an exercise of section 105 power be tied to another Bankruptcy Code section and not merely to a general bankruptcy concept or objective." Furthermore, Section 105(a) of the Bankruptcy Code is derived from the federal All Writs Act, with respect to which this Court has explained does not authorize federal courts to issue *ad hoc* writs whenever compliance with statutory procedures appears inconvenient or less appropriate. *Pa. Bureau of Corr. v. U.S. Marshall Serv.*, 474 U.S. 34, 43 (1985). *See also* Steve H. Nickles & David G. Epstein, *Another Way of Thinking About Section 105(a) and Other Sources of Supplemental Law Under the Bankruptcy Code*, 3 Chapman Law Review 7-20 (Spring 2000) (observing that aggressive uses of Section 105 to achieve non-statutory remedies, including substantive consolidation, may result in a violation of Constitutional separation of powers principles). In sum, Section 105(a) is not a delegation of quasi-legislative powers to bankruptcy judges.

CONCLUSION

The opinion of the court of appeals is not in conflict with that of any other court of appeals. The Petition fails to meet the criteria established by this Court for granting review by certiorari. The Petition should be denied.

Respectfully submitted,

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